



UNDERSTANDING U.S. TAXATION OF FOREIGN INVESTMENT IN REAL PROPERTY

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OVERVIEW OF TOPICS

- Taxation of Income from Investments in U.S. Real Property by Foreign Persons
 - Gross (FDAP) vs. Net Basis (ECI) Taxation
- Taxation on Disposition of USRPI
 - What is a USRPI?
 - What constitutes a Disposition?
- Withholding on Disposition of USRPI
 - Applicable withholding provisions on dispositions of USRPIs
- Reducing or Eliminating the Withholding Obligation
 - Withholding certificates
 - Notices of Non-recognition
- Structuring Investments in U.S. Real Estate
- FIRPTA Considerations in Cross-Border M&A Transactions



TAXATION OF INCOME FROM U.S. REAL PROPERTY INVESTMENTS

TAXATION OF INCOME FROM U.S. REAL PROPERTY

4 MAIN CLASSES OF INCOME

- Rental income from leasing the property
- Interest income from debt investments
- Dividend income from corporation holding U.S. real estate investment
- Income on disposition of U.S. real estate investment

TAXATION OF INCOME FROM U.S. REAL PROPERTY

U.S. TAXATION OF INCOME ON A NET OR GROSS BASIS

- Income effectively connected with the conduct of a U.S. trade or business (“ECI”)
 - Taxation on a net basis
 - Gain or loss from the disposition of a USRPI treated as ECI per Section 897(a).
- Fixed, determinable, annual, or periodic income that is not ECI.
 - Taxation on a gross basis
 - Applies to rental income, interest income, or dividend income that is not ECI

TAXATION OF INCOME FROM U.S. REAL PROPERTY

IS INCOME ECI?

DO ACTIVITIES CONSTITUTE A TRADE OR BUSINESS?

- Essential question in determining whether real estate activities constitute a U.S. trade or business is whether activities are extensive, regular and continuous.
 - Ownership of a single property that is leased on a triple net lease not considered a U.S. trade or business whereas ownership of several U.S. properties that are actively managed (directly or through an agent) would be a U.S. trade or business.
- Then must determine whether income is effectively connected with the conduct of such U.S. trade or business to determine whether income will be treated as income effectively connected with the conduct of a U.S. trade or business (“ECI”)

TAXATION OF INCOME FROM U.S. REAL PROPERTY

NET ELECTION

- The “Net Election” under section 871(d) or 882(d) allows income derived from real property to be treated as ECI
 - Allows the taxpayer to deduct depreciation, real estate taxes, and other expenses related to the US real estate business and not be subject to general 30% gross basis taxation applicable to fixed, determinable, annual, or periodic income.
 - Net Election may also be available under treaty. See, e.g., Article 6(5) of the 2006 U.S. Model Income Tax Treaty.
- Making the Election
 - File a statement with return (or amended return filed within SOL for claiming refund – 3 years from filing or 2 years from payment)
 - “Protective” Elections may be made if not sure whether income from U.S. real estate activities constitute a trade or business or whether will have ECI, but election will only apply to non-ECI income (but must have income from U.S. real property in year of election that is not from a disposition).
 - Stays in effect unless revoked within SOL for claiming refund (then must get consent or IRS to revoke the election). May be able to make year-by-year election under older treaties.



TAXATION ON DISPOSITIONS OF USRPIs

TAXATION ON DISPOSITIONS OF USRPIS

SECTION 897 - SUBSTANTIVE TAX AND 1445 - WITHHOLDING TAX

- Section 897 treats gain or loss from the disposition of a USRPI as ECI
- Section 1445 imposes a withholding obligation on the disposition of USRPI
 - Withholding obligation generally imposed on transferee of USRPI
 - 15% of amount realized in most cases (increased from 10% effective 2/16/16)
- Thus, must determine whether an asset is a USRPI and whether there has been a disposition of the asset to determine whether there is a taxable transaction and/or withholding obligation.

TAXATION ON DISPOSITIONS OF USRPIS

WHAT IS A USRPI? – 3 MAIN CATEGORIES

- A direct interest in real property located in the United States.
- An interest in a U.S. Real Property Holding Corporation (“USRPHC”).
- An interest in a partnership to the extent gain on its disposition would be attributable to USRPIs.

TAXATION ON DISPOSITIONS OF USRPIS

- A direct interest in real property located in the United States.
 - Land as well as growing crops, timber, mines, wells, and other natural deposits (until severed from the land or extracted from the ground).
 - Buildings, or other permanent improvements and the structural components of either (i.e. those components required for the operation or maintenance of buildings and other inherently permanent structures).
 - Personal property “associated” with the use of real property.
 - Property used in mining, farming, and timber activities.
 - Property used to construct or otherwise carry out improvements to real property.
 - Property used in the operation of a facility providing accommodations (apt, hotel, etc.).
 - Property used by a lessor to provide a furnished office or work space (i.e. office furniture and equipment installed or provided by landlord).
 - Exceptions: When personal property will not be treated as a USRPI.
 - > Personal property disposed of 1 year before or 1 year after real property.
 - > Personal property and real property are sold to unrelated parties within 90 day window.

TAXATION ON DISPOSITIONS OF USRPIS

➤ USRPHCs

- A domestic corporation will be considered a USRPHC where the FMV of its USRPIs equals or exceeds 50% of the FMV of all its interests in real property (including U.S. real property and real property outside the United States) as well as any other assets used or held for use in a trade or business.
- The regulations provide an alternate “book value” test where a corporation will be presumed not to be a USRPHC where its accounting book value of USRPIs is 25% or less of the total accounting book value of all its interests in real property as well as any other assets used or held for use in a trade or business.
- Equity Interests in subsidiary foreign corporations may be considered USRPIs for purposes of determining whether domestic corporation is USRPHC if foreign corporation would be a USRPHC if domestic.
- “Look Through” Rules for determining assets of domestic corporation
- Proportionate value of underlying assets - 50% or greater owned USRPHC subsidiaries AND partnerships, trusts, or estates.
- FMV of interest in subsidiary – 50% or less owned USRPHC subsidiaries
- 318 constructive ownership rules apply with modification.

TAXATION ON DISPOSITIONS OF USRPIS

➤ USRPHCs – Domestic corporations

- ANY equity interest in ANY domestic corporation is presumed to be a USRPI unless:
 - (A) (i) as of the date of the disposition, such corporation did not hold any USRPIs AND (ii) all of the USRPIs owned by such corporation during the “applicable period” were disposed of in fully taxable transactions, OR
 - (B) taxpayer establishes that such corporation was at no time a USRPHC during the applicable period.
- The “applicable period” is the shorter of (i) the 5 year period preceding the date of the disposition of such interest, or (ii) the period the relevant taxpayer owned the interest.

➤ **What is the takeaway here for multinationals with domestic corporation in group?** **Notice requirements under Treas. Reg. 1.1445-2(c)(3) and 1.897-2(h)(2).**

TAXATION ON DISPOSITIONS OF USRPIS

➤ USRPHCs – Exceptions

- Publicly traded corporations only treated as USRPHCs to 5% or greater shareholders (constructive ownership rules of 318 apply with certain modifications).

➤ Not USRPIs

- An interest “solely as a creditor” not treated as a USRPI
- An interest “solely as a creditor” does not include an interest that is, in whole or in part, a direct or indirect right to share in the appreciation in value of an interest in, assets of, gross or net proceeds of, or profits derived by, an entity.
- Interests in “domestically controlled qualified investment entity”
- Real estate investment trusts (“REITs”) where less than 50% of fair market value of outstanding stock is held by foreign persons during the shortest of (i) 5 year period preceding the determination date, (ii) the period since June 18, 1980, and (iii) the period during which the REIT existed.

TAXATION ON DISPOSITIONS OF USRPIS

➤ Interests in partnerships

- Not explicitly treated as USRPIs under general rules of Section 897
- Section 897(g) provides that *money or property received* in exchange for an interest in a partnership (or trust or estate) is treated as proceeds from the sale or exchange of a USRPI to the extent the sales proceeds are attributable to underlying USRPIs
- Partnership may be domestic or foreign (no distinction under 897).
- Full withholding will apply to proceeds from the disposition of an interest in a “50/90” partnership, unless other exceptions apply.
- For purposes of withholding rules, an interest in a partnership is treated entirely as a USRPI if 50% of gross value of partnership assets consists of USRPIs and 90% consists of USRPIs plus cash and cash equivalents
- For purposes of 897(g), however, such interest is treated as a USRPI only to the extent that the *gain* on the disposition is attributable to USRPIs (and not cash, cash equivalents or other property).
- USRPI status of partnership interest in partnerships that do not meet 50/90 test.
 - Unclear, but reasonable to conclude USRPI to extent of gain
- Note impact of 897(g) on 897(e) in nonrecognition exchanges.

TAXATION ON DISPOSITIONS OF USRPIS

➤ What is a disposition?

- A “disposition” means any transfer that would constitute a disposition by the transferor for any purpose under the Internal Revenue Code and the regulations thereunder.
- Must be careful to identify all dispositions on actual transactions as well as transactions deemed to occur under the code (e.g. transactions deemed to occur on technical terminations of partnerships, changes in classification, etc.).
- “Gifts” or gratuitous transfers (such as a transfer to a trust) should not trigger FIRPTA unless debt is in excess of basis (and thus gain is recognized on the transfer).
- Nonrecognition provisions may apply to defer recognition of gain or loss where the transferor of a USRPI receives an interest in return which would be subject to U.S. tax upon a later sale.



WITHHOLDING TAX ON DISPOSITIONS OF USRPIS

WITHHOLDING TAX ON DISPOSITION OF USRPI

➤ Which withholding provision applies?

- 1445(a) – Disposition of a USRPI (as defined in 897(c)) by a Foreign Person (foreign corporation, partnership, or individual) – withholding of 10% of amount realized.
 - > Since 897(c) does not define a partnership interest as a USRPI, section 1445(e)(5) provides relevant rule for disposition of partnership interests by foreign persons.
 - > 1445(e)(5) essentially expands 1445(a) to dispositions of interests in 50/90 partnerships.
- 1445(e)(1) – Disposition by a domestic partnership with foreign partner subject to withholding on 35% of *gain* realized that is allocable to (direct) foreign partners.
 - > 1446 withholding will trump 1445(e)(1) withholding if ECTI allocable to foreign partner.
- 1445(e)(2) – Distribution by foreign corporation in which gain is recognized under sections 897(d) or (e) subject to withholding on 35% of gain recognized on distribution.
- 1445(e)(3) – Distribution by USRPHC to foreign shareholders if a redemption under section 302 or liquidating distribution (or 301 distribution that is not a dividend) – withholding on 10% of the amount realized by the foreign shareholder.
- 1445(e)(4) – Taxable Distributions by Domestic or Foreign Partnerships.
 - > No withholding applies until regulations are issued.



REDUCING OR ELIMINATING THE WITHHOLDING TAX

REDUCING OR ELIMINATING WITHHOLDING TAX

➤ Exceptions to the general rule

- Transferor furnishes non-foreign affidavit.
- IRS Withholding Certificate Obtained.
 - > Maximum tax liability
 - > Exemption from tax
 - > Agreement for the payment of tax
 - > Transferor or Transferee may apply for withholding certificate (See Form 8288-B).
 - > Can take several months to be processed so best to apply well in advance of proposed transaction if wish to rely on withholding certificate to reduce withholding obligation.
- Nonrecognition provision applicable and relevant “notice of nonrecognition obtained” and filed within 20 days of applicable transfer or disposition.

REDUCING OR ELIMINATING WITHHOLDING TAX

➤ Notice of nonrecognition

- Determine which nonrecognition provision applies (e.g. 351, 354, 332, 721, etc.)
 - > Note that if nonrecognition applies to only part of the gain realized on the transfer (e.g. boot in a reorganization), then the exemption from withholding will not apply and will need to apply for withholding certificate to reduce or eliminate withholding obligation. Treas. Reg. 1.1445-5(b)(2), 1.1445-2(d)(2)(ii)(A).
- Determine that nonrecognition treatment is permitted under Section 897(e) and the regulations thereunder.
 - > USRPI for USRPI general requirement (several exceptions however).
- Assuming nonrecognition treatment is available to fully avoid recognition of gain under Section 897, determine which Notice of Nonrecognition procedure is applicable (2 types)
 - > Treas. Reg. 1.1445-2(d)(2) Notices & Treas. Reg. 1.1445-5(b)(2) Notices.
 - > -2 generally applicable to 1445(a) and (e)(5) withholding.
 - > -5 generally applicable to 1445(e) withholding (other than (e)(5)).

REDUCING OR ELIMINATING WITHHOLDING TAX

➤ Notice of Nonrecognition

- Treas. Reg. 1.1445-2(d)(2) Notices of Non-Recognition.
- 1st, on or before transfer, transferor provides notice to transferee, verified as true and signed under the penalties of perjury, containing the following information:
 - > Statement that the document constitutes a notice of nonrecognition transaction pursuant to the requirements of Treas. Reg. 1.1445-2(d)(2);
 - > The name, US Tax ID, and address of Transferor providing the notice;
 - > A statement that no gain or loss is required to be recognized by the transferor; and
 - > A brief description of the transfer and a brief summary of the law and facts supporting the claim that recognition of gain or loss is not required.
- 2nd, within 20 days of the transfer, a copy of the notice of nonrecognition is sent to the IRS with a cover letter setting forth name, US Tax ID Number, and address of Transferee providing notice to the service.

REDUCING OR ELIMINATING WITHHOLDING TAX

➤ Notice of nonrecognition

- Treas. Reg. 1.1445-5(b)(2) Notices of Non-Recognition
- Within 20 days of the transfer, entity submits a notice of nonrecognition to the IRS containing the following:
 - > Statement that the document constitutes a notice of nonrecognition transaction pursuant to the requirements of Treas. Reg. 1.1445-2(b)(2)(ii);
 - > The name, US Tax ID, and address of the entity submitting the notice;
 - > The name, US Tax ID, and address of each foreign person with respect to which withholding would otherwise be required; and
 - > A brief description of the transfer and a brief summary of the law and facts supporting the claim that recognition of gain or loss is not required.
- Where should the notices be sent?
 - > Send to Internal Revenue Service Center P.O. Box 409101, Ogden, UT 84409.

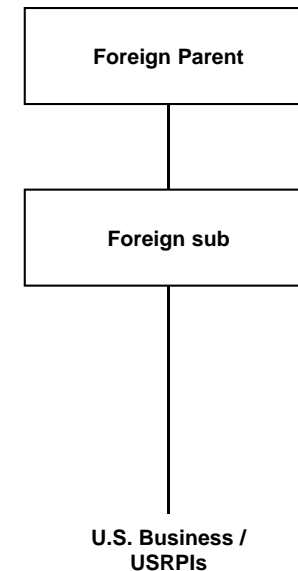


STRUCTURING INVESTMENTS IN U.S. REAL ESTATE

STRUCTURING INVESTMENTS IN U.S. REAL ESTATE

➤ Direct investment by foreign corporation

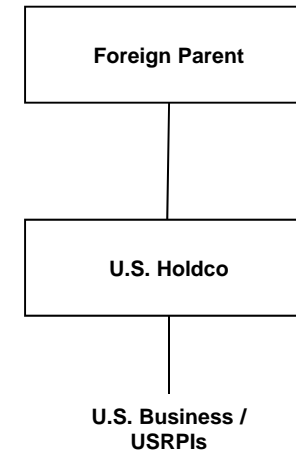
- Main Benefits
 - > Individual shareholders and foreign parent have no obligation to file U.S. tax return
 - > No U.S. withholding taxes at shareholder level on dividend distributions from foreign sub to foreign parent or from foreign parent to shareholders.
- Negatives
 - > U.S. corporate tax applies; and
 - > 30% Branch Profits Tax (“BPT”) of “dividend equivalent amount” of the foreign corporation will be imposed – unless all USRPIs have been disposed of in foreign taxable transactions and foreign corporation liquidates.
 - > Applicable Income Tax Treaty may also eliminate BPT
 - > FIRPTA withholding will apply on every taxable disposition of USRPI by the foreign corporation
 - > Practical Considerations in having a foreign entity own U.S. real estate



STRUCTURING INVESTMENTS IN U.S. REAL ESTATE

➤ Direct investment by U.S. Corporation

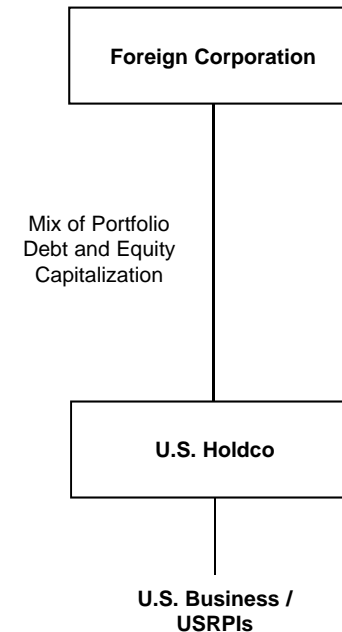
- Main Benefits
 - > Branch Profits Tax is not applicable.
 - > No U.S. tax return for Foreign Parent as U.S. HoldCo will be the entity engaged in a U.S. trade or business.
 - > Once USRPI is sold in fully taxable transaction, the U.S. HoldCo can be liquidated and proceeds will not be subject to U.S. withholding taxes as this will be treated as non-U.S. source capital gains.
 - > Interim dividend distributions will be subject to U.S. withholding tax unless reduced by applicable treaty.



STRUCTURING INVESTMENTS IN U.S. REAL ESTATE

➤ Leverage

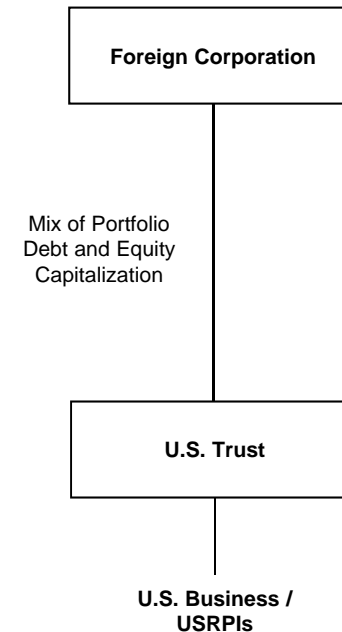
- Debt funding may be used to generate interest deduction at level of U.S. HoldCo to offset taxable income of the U.S. HoldCo while partially or wholly eliminating U.S. taxation to the foreign corporation on the payment of interest
- Interest may be subject to reduced rate of withholding under applicable treaty
- Caution: 163(j) – Anti-Interest stripping rules where excess interest expense (generally >50% of income)
- Caution: Conduit Financing Restrictions
 - > Avoid with equity investments by U.S. HoldCo



STRUCTURING INVESTMENTS IN U.S. REAL ESTATE

➤ Investment Trust Structures

- Debt funding may be used to generate interest deduction at level of U.S. HoldCo to offset taxable income of the U.S. HoldCo while partially or wholly eliminating U.S. taxation to the foreign corporation on the payment of interest
- Assuming trust is formed as a non-grantor trust, interest payments should qualify for portfolio interest.
- Restrictions for Investment Trust Classification – No change in the investment
- Will generally prevent interim distributions to foreign corporation → May consider dual beneficiary trust structure to allow for interest distributions of cash





FIRPTA CONSIDERATIONS IN CROSS-BORDER M&A TRANSACTIONS

CROSS BORDER M&A TRANSACTIONS

➤ USRPI FOR NON-USRPI (STOCK IN FOREIGN CORPORATION)

- The general rules provide that upon the transfer by a foreign person of a USRPI, any nonrecognition provision of the Code will only apply to the extent that the transferred USRPI is exchanged for a USRPI which, immediately following the exchange would be subject to U.S. taxation upon its disposition. Treas. Reg. 1.897-6T(a)(1).
- Certain Exceptions exist in regard to the USRPI for USRPI requirement
 - > Stock received in section E or F reorganizations qualifying for nonrecognition pursuant to section 354(a) is deemed to be the same interest in the corporation whose stock was exchanged for purposes of determining whether the interest received is a USRPI. Notice 99-43
 - > Certain Foreign to Foreign Exchanges in 351 transactions or 368 reorganizations. Treas. Reg. 1.897-6T(b) as modified by Notice 2006-46.
 - > Foreign to Foreign 332 Liquidations. Treas. Reg. 1.897-5T(c)(2)
 - > Inbound A (and 368(a)(2)(D)), C, and F Reorganizations. Treas. Reg. 1.897-5T(c)(4), as modified by Notice 89-85 and Notice 2006-46.

CROSS BORDER M&A TRANSACTIONS

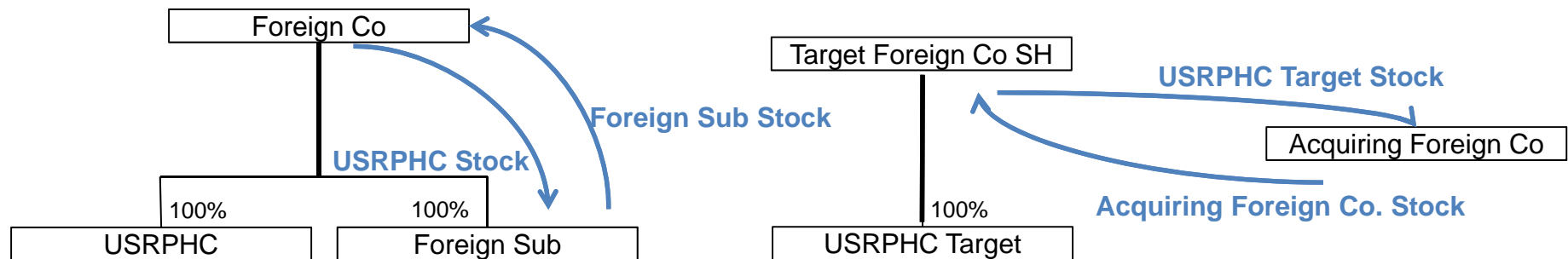
➤ Foreign to Foreign Exchanges in 351 transactions or 368 reorganizations.

- Treas. Reg. 1.897-6T(b) as modified by Notice 2006-46.
- 361 nonrecognition available on the transfer of a USRPI to a foreign corporation in connection with a 368(a)(1)(A), 368(a)(1)(C) reorganization (including a reorganization pursuant to 368(a)(2)(D) or (E) provided that the transferor foreign corporation would not have been a USRPI at any time during the previous 5 years if it were a domestic corporation (a “low USRPI percentage” merger).
 - > 361 nonrecognition also available to certain public foreign-to-foreign mergers where (i) stock of transferor and transferee are regularly traded on established securities market, and the stock of the transferee continues to be after the merger, and (ii) no foreign shareholder of the transferor owned a greater than 5% interest during the previous 5 years if the transferor would have been a USRPI if it were a domestic corporation during such period.
 - > For foreign-to-foreign mergers not falling into the 2 exceptions above, 361 nonrecognition may still be available for transferor foreign corporation if, immediately after the merger, the shareholders of the foreign corporation own more than 50% of the voting stock of the transferee corporation. This provision is intended to facilitate internal restructuring transactions.
- 361 nonrecognition treatment available to foreign transferor where stock of the transferee foreign corporation is distributed by the transferor corporation in a distribution that, as the shareholder level, qualified for 354(a) nonrecognition treatment (i.e. only applicable to acquisitive D reorgs and not divisive D reorgs).

CROSS BORDER M&A TRANSACTIONS

➤ Foreign to Foreign Exchanges in 351 transactions or 368 reorganizations

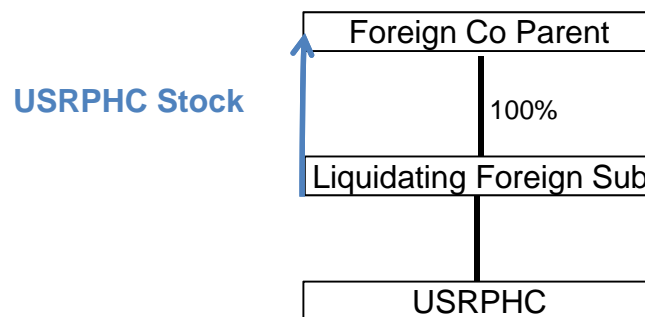
- 351 nonrecognition and 354 nonrecognition in a foreign-to-foreign reorganization under 368(a)(1)(B) will be available to a transferor foreign corporation on the transfer of a USRPI to a foreign corporation only if the USRPI being transferred is stock in a USRPHC and substantially all of the stock of the transferee foreign corporation is owned by the transferor foreign corporation.
 - > Transferor will recognize share of gain inherent in the stock of the USRPHC that was transferred in the exchange if the transferor foreign corporation disposes of stock in the transferee foreign corporation within 1 year after receipt.
 - > Transfer of an option to acquire USRPHC stock does not seem to be covered by this provision.



What if Foreign Co. receives cash as well as stock in exchange for USRPHC stock?
What if USRPHC was just an interest in real property?

CROSS BORDER M&A TRANSACTIONS

- Foreign to Foreign Exchanges in 332 transactions. Treas. Reg. 1.897-5T(c)(2).
 - 332 nonrecognition available for transferor foreign corporation liquidating into parent foreign corporation where
 - > (a) at the time of the distribution of the USRPI, the distributees (parent foreign corporation) would be subject to U.S. tax upon disposition of such USRPI
 - > (b) the basis of the USRPI in the hands of the parent foreign corporation is not greater than the basis in the hand of the liquidating foreign corporation, increased by the amount of gain (if any) recognized by the liquidating foreign corporation on the distribution, and
 - > (c) the transferee foreign corporation satisfied the relevant FIRPTA filing requirements.



CROSS BORDER M&A TRANSACTIONS

➤ Inbound A (and 368(a)(2)(D)), C, and F Reorganizations.

- 361(c) nonrecognition treatment on distribution of stock to shareholders in a reorganization where a foreign corporation transfers a USRPHC interest to U.S. corporation in exchange for stock of the U.S. corporation (or, as may be applicable, stock in the parent of the U.S. corporation), and then distributes the stock to its shareholders if:
 - > (a) at the time of the distribution, the distributees (foreign corporation shareholders) would be subject to U.S. tax upon disposition of such stock
 - > (b) the transferor foreign corporation and its shareholder comply with the relevant FIRPTA filing requirements, and
 - > (c) the transferor foreign corporation pays an amount equal to any taxes that section 897 would have imposed on all persons who disposed of interests in the transferor foreign corporation during the 10 year period proceeding the reorganization if the transferor foreign corporation were a domestic corporation.

